Franchising and its Benefits

Abstract:

Business opportunities and franchises are two ways to start a business without having to start from scratch, offering prospective business owners a proven system to operate with. While they are similar, and have many overlapping features, they have distinct differences that should be acknowledged before an entrepreneur signs on the dotted line to proceed with either. Buying a small business is a major career step. One of the first decisions you'll need to make relates to the type of business you hope to acquire. Specifically, you will need to decide whether to buy an independent business or a franchise. In this paper we will explain you the ideology of franchises business, what you should do before buying a franchise and how to buy a franchise, how it will work and what the advantages a franchisee has.

Introduction:

A franchise is the agreement or license between two legally independent parties which gives:

- A person or group of people (franchisee) the right to market a product or service using the
- trademark or trade name of another business (franchisor)
- the franchisee the right to market a product or service
- using the operating methods of the franchisor
- the franchisee the obligation to pay the franchisor fees
- for these rights
- the franchisor the obligation to provide rights and
- support to franchisees

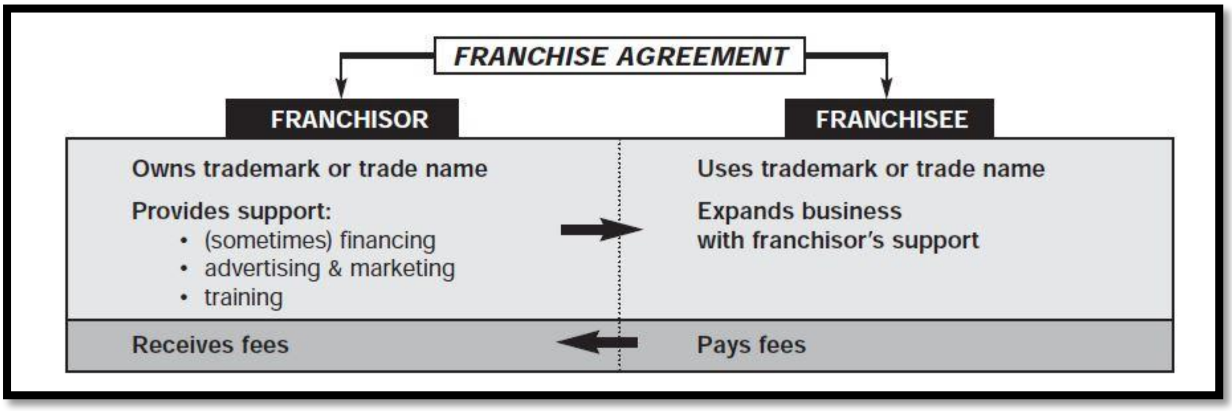


Figure 1

Other people say that, a **franchise** is defined as the right or license granted by a company (franchisor) to an individual or group (franchisee) to market its products or services in a specific territory.

Three common types of franchises are:

- **Business Format:** Probably the most popular form of franchising. The franchisor licenses their brand to a franchisee for use with a predetermined way of conducting business.
- **Product:** The franchisor grants the franchisee permission to sell/distribute a product using their logo, trademark and trade name.
- **Manufacturing:** The franchisor permits the franchisee to manufacture their products (i.e. food) and sell them using their trademark and name.

When the purchase of a franchise is made, the purchaser is required to comply with strict guidelines and rules regarding the operation of the business unlike in a business opportunity. These guidelines are in place to protect others within the system and maintain brand consistency. And unlike most business opportunities, costs paid to the franchisor don't end with the initial sale.

Royalty payments are commonly collected for as long as the franchisee owns their franchise. In exchange for these payments, the franchisee will receive continued support, such as marketing assistance.

In acquiring a franchise, the potential franchisee goes through what is traditionally a much more extensive vetting process to complete the deal.

In addition to an interview, a potential franchisee will first have to complete an application that details his or her background and work experience to assess how he or she would fit into the franchise's system, and provides detailed financial information to find out if he or she can sustain the business until it is profitable if necessary.

Then, assuming the potential franchisee is deemed a suitable candidate, the franchisor will present a franchise contract that should be gone over with legal counsel before it is agreed to.

The franchisor also makes several disclosures upfront. Franchisors are required by the Federal Trade Commission (FTC) to present potential franchisees with a Franchise Disclosure Document (FDD) at least 14 days before a contract is signed. A FDD is a document that outlines the history of the business, all the franchisees in a franchise's system, turnover rates, terminations, fees, rules, restrictions, and numerous other items pertaining to that particular franchise.

Common Franchise Terms that you should know:

Business format franchise – this type of franchise includes not only a product, service and trademark, but also the complete method to conduct the business itself, such as the marketing plan and operations manuals

Disclosure statement – also known as the UFOC, or Uniform Franchise Offering Circular, the disclosure document provides information about the franchisor and franchise system

Franchise – a license that describes the relationship between the franchisor and franchisee including use of trademarks, fees, support and control franchise agreement – the legal, written contract between the franchisor and franchisee which tells each party what each is supposed to do.

Franchisee – the person or company that gets the right from the franchisor to do business under the franchisor's trademark or trade name.

Franchising – a method of business expansion characterized by a trademark license, payment of fees, and significant assistance and/or control.

Franchisor – the person or company that grants the franchisee the right to do business under their trademark or trade name product distribution franchise – a franchise where the franchisee simply sells the franchisor's products without using the franchisor's method of conducting business.

Royalty – the regular payment made by the franchisee to the franchisor, usually based on a percentage of the franchisee's gross sales.

Trademark – the franchisor's identifying marks, brand name and logo that are licensed to the franchisee.

UFOC – the Uniform Franchise Offering Circular, UFOC, is one format for the disclosure document which provides information about the franchisor and franchise system to the prospective franchisee.

Things to Do Before You Buy a Franchise:

Buying a franchise can be a great move for a would-be entrepreneur who doesn't want to create a new business from scratch. In theory, franchisees acquire a model that already works on every level, from branding to pricing to marketing. A ready clientele eagerly spends on Dunkin' Donuts, McDonald's and 7-11. The market has tested the best recipes for glazed crullers, Egg McMuffins and the right combo of energy drinks to stock next to the register. But making a go as a successful franchisee can be a lot more complicated than simply finding an appealing brand and plunking down some cash. For a taste of what can go wrong, see Forbes' piece about the problems at sandwich franchise Quiznos, which paid $206 million to

settle a suit brought by franchisees who claimed the chain had oversold its markets and excessively marked up supplies.

Figure 2

If you're thinking of becoming a franchisee, how should you prepare yourself? We asked three professionals with extensive knowledge of the franchising world. Ed Teixeira is both a former franchisor and former franchisee, and the author of two books on franchising, including The Franchise Buyer's Manual. Josh Brown is a Carmel, Indiana lawyer who specializes in franchising, and Sean Kelly is a former executive at the successful Amish pretzel franchise Auntie Anne's. Kelly runs the muck-raking website, Unhappy Franchisee. They recommend you do these 12 things before you buy a franchise.

Give yourself a personality test:

There's a reason military veterans tend to be successful franchisees, says Brown. They're used to following the rules and operating within a highly regulated system. If you're the creative type who likes to cook without recipes, paint walls wild colors and experiment with mood lighting, you're probably not cut out to be a franchisee, says Kelly. "You have to know that you're going to be an implementer, not a creator," he says.

Study the field:

Avail yourself of publicly available information on the ABCs of franchising. An excellent place to start: The Federal Trade Commission's Guide to Buying a Franchise. Did you know that many franchisees are required to spend a designated amount on advertising and yet have no control over how those ad dollars are spent? Two other helpful sites: The International Franchising Association's Franchising 101 guides and The American Association of Franchisees and Dealers' Road Map to Selecting a Franchise.

Assess your strengths:

How do you feel about cold calling? Business-to-business sales? Teixeira used to run a franchise called Vehicle Tracking Solutions, which sold GPS systems to trucking companies. The product involved technology, which attracted tech-savvy franchisees. But some of them hated sales, the most essential part of the business. They flopped. Teixeira recommends asking friends and family to help you evaluate how well your personality matches the business you're considering. Experience also matters. Thinking of running an Applebee's? What do you know about food service and management? "There's a big misconception out there that franchises are just a business in a box," says Brown.

Count your money:

Look beyond the minimum requirement for buying a franchise, usually listed as the franchise fee and the cost of equipment. Getting a franchise up and running can involve hefty marketing costs and the need to survive on break-even books, or a period of net losses, before your business catches on. Even if you're franchising a well-known brand like 7-11, customers have to discover your new location. The Franchise Disclosure Document (FDD), which franchisors must make available to would-be franchisees, is required to list additional working capital under item No. 7. But in the FDD, Teixeira says most franchisors calculate three months' worth of expenses, when it's wiser to think of your likely expenses for up to six months. The FTC's guide says it may take a year to become profitable. You should have access to capital that will cover both business expenses for six months and personal living expenses for a year.

Beware of franchise consultants:

Most franchise consultants are paid salespeople, according to Sean Kelly. Consultants want to get you signed onto a franchise deal as quickly as possible, because their cut is often half of the franchise fee of $20,000 or $30,000. Ask them to make their financial arrangements clear, up front.

Don't believe the "Franchise Lie."

An urban legend about franchise failure rates persists: Franchises only fail 5% of the time. Not true. They fail at roughly the same rate as other businesses, which is to say two-thirds of businesses with employees last two years, and half survive at least five, according to 2012 findings by the Small Business Administration. Yet many franchisors make claims like this: "after five years in operation, more than 90% of franchises continue to operate while less than 25% of privately owned companies stay in business." Wrong.

Dig for dirt:

Take advantage of sites like Sean Kelly's Unhappy Franchisee and search for negatives about the franchise you're considering. For example, Kelly has run a series of exposés on NY Bagel Café, documenting the stores' high closure rate. (A consultant to the chain, Richard Taggert,

disputes Kelly’s reports and says the company has had only had a handful of closings in the last decade.) Blue Mau Mau also reports on the franchise industry.

Talk to franchisees:

FDDs include the names and phone numbers of current franchisees. Talk to at least 10. Ask about pros, cons, and hidden costs. What did they learn that they didn’t glean from their research before they became franchisees? How long did it take them to become profitable? How much did they budget for their enterprise, and how much did they wind up spending? What was the toughest part of building the business? How supportive is headquarters? How challenging is it to hire good staff? Ask if, given what they know now, they would do it again or recommend the franchise to a close family member? Keep in mind that “ego is a big thing,” says Teixeira. Some franchisees might not want to admit that they’ve struggled. All the more reason to talk to as many as you can.

Read the entire Financial Disclosure Document (FDD):

The FTC’s online guide describes how to make your way through this document, which can run 50 pages or more. Don’t be intimidated. The FDD offers a gold mine of information, like bankruptcy filings by the franchisor, litigation involving the company and/or its executives, the type of training the franchisor offers franchisees, and costs that may not seem obvious, like opening day expenses when headquarters may want you to give away free stuff and do special promotions. (For more on evaluating the FDD, click here.)

Consider hiring professional help:

If you have accounting know-how and feel comfortable reading a balance sheet, you’ve insured a past business and you’ve negotiated legal contracts, you may not need an accountant, insurance agent and lawyer. But with some self-interest, lawyer Josh Brown says you should have a lawyer and other professionals review your financial health and how it will be affected by the franchise arrangement before you sign a franchise contract. His pitch for his services: “If you’re buying a business that costs between $150,000 and $1 million, you need an attorney to look at the documents and tell you what they mean.” He says he charges “a few thousand dollars” to help most of his franchisee clients get started. An accountant can help you assess whether the numbers add up.

Explore working in a store:

This is the best way to see how a franchised business works from the inside, and whether your personality fits the company culture. Domino’s strongly favors franchise applicants who have worked their way up from delivering pizzas and since 2008, Dutch Bros., a successful drive-through coffee franchise based in Grants Pass, OR, has stuck to a policy of granting

franchises only to people who have worked for the chain for at least three years. Kelly recommends spending six months as a worker before you become a franchisee.

Do a cost/benefit analysis:

Make an old-fashioned pro v. con list. Draw a line down the center of a piece of paper and on one side, write down the benefits you're getting, like established brand, proven market, training, recipes if it's a food franchise, staffing guidelines, store design. On the other side list the costs and liabilities, including franchise fee, money you're required to pay for marketing, mark-ups on merchandise and ingredients the chain requires you to buy, the share of sales you must pay in royalties. Consider whether you could hire a consultant to help you open up your own donut or sandwich shop, and instead of paying royalties, mark-ups and marketing fees, keep that money for yourself.

Advantages of Franchising

In Franchise Your Business, author and franchise consultant Mark Siebert delivers the ultimate how-to guide to employing one of the greatest growth strategies ever -- franchising. Siebert shares decades of experience, insights, and practical advice to help grow your business exponentially through franchising while avoiding the pitfalls. In this edited excerpt, Siebert digs into the details behind just what makes franchising a growth strategy you might want to consider.

Figure 3

The primary advantages for most companies entering the realm of franchising are capital, speed of growth, motivated management, and risk reduction -- but there are many others as well.

1. Capital:

The most common barrier to expansion faced by today's small businesses is lack of access to capital. Even before the credit-tightening of 2008-2009 and the "new normal" that ensued, entrepreneurs often found that their growth goals outstripped their ability to fund them.

Franchising, as an alternative form of capital acquisition, offers some advantages. The primary reason most entrepreneurs turn to franchising is that it allows them to expand without the risk of debt or the cost of equity. First, since the franchisee provides all the capital required to open and operate a unit, it allows companies to grow using the resources of others. By using other people's money, the franchisor can grow largely unfettered by debt.

Moreover, since the franchisee -- not the franchisor -- signs the lease and commits to various contracts, franchising allows for expansion with virtually no contingent liability, thus greatly reducing the risk to the franchisor. This means that as a franchisor, not only do you need far less capital with which to expand, but your risk is largely limited to the capital you invest in developing your franchise company -- an amount that is often less than the cost of opening one additional company-owned location.

2. Motivated Management

Another stumbling block facing many entrepreneurs wanting to expand is finding and retaining good unit managers. All too often, a business owner spends months looking for and training a new manager, only to see them leave or, worse yet, get hired away by a competitor. And hired managers are only employees who may or may not have a genuine commitment to their jobs, which makes supervising their work from a distance a challenge.

But franchising allows the business owner to overcome these problems by substituting an owner for the manager. No one is more motivated than someone who is materially invested in the success of the operation. Your franchisee will be an owner -- often with his life's savings invested in the business. And his compensation will come largely in the form of profits. The combination of these factors will have several positive effects on unit level performance. Long-term commitment. Since the franchisee is invested, she will find it difficult to walk away from her business.

Better-quality management. As a long-term "manager," your franchi-see will continue to learn about the business and is more likely to gain institu-tional knowledge of your business that will make him a better oper-ator as he spends years, maybe decades, of his life in the business.

Improved operational quality. While there are no specific studies that measure this variable, franchise operators typically take the pride of ownership very seriously. They will keep their locations cleaner and train their employees better because they own, not just manage, the business.

Innovation. Because they have a stake in the success of their business, franchisees are always looking for opportunities to improve their business -- a trait most managers don't share.

Franchisees typically out-manage managers. Franchisees will also keep a sharper eye on the expense side of the equation -- on labor costs, theft (by both employees and customers) and any other line item expenses that can be reduced.

Franchisees typically outperform managers. Over the years, both studies and anecdotal information have confirmed that franchisees will outperform managers when it comes to revenue generation. Based on our experience, this performance improvement can be significant -- often in the range of 10 to 30 percent.

3. Speed of Growth

Every entrepreneur I've ever met who's developed something truly innovative has the same recurring nightmare: that someone else will beat them to the market with their own concept. And often these fears are based on reality.

The problem is that opening a single unit takes time. For some entrepreneurs, franchising may be the only way to ensure that they capture a market leadership position before competitors encroach on their space, because the franchisee performs most of these tasks. Franchising not only allows the franchisor financial leverage, but also allows it to leverage human resources as well. Franchising allows companies to compete with much larger businesses so they can saturate markets before these companies can respond.

4. Staffing Leverage

Franchising allows franchisors to function effectively with a much leaner organization. Since franchisees will assume many of the responsibilities otherwise shouldered by the corporate home office, franchisors can leverage these efforts to reduce overall staffing.

5. Ease of Supervision

From a managerial point of view, franchising provides other advantages as well. For one, the franchisor is not responsible for the day-to-day management of the individual franchise units. At a micro level, this means that if a shift leader or crew member calls in sick in the middle of the night, they're calling your franchisee -- not you -- to let them know. And it's the franchisee’s responsibility to find a replacement or cover their shift. And if they choose to pay salaries that aren't in line with the marketplace, employ their friends and relatives, or spend money on unnecessary or frivolous purchases, it won't impact you or your financial returns. By eliminating these responsibilities, franchising allows you to direct your efforts toward improving the big picture.

6. Increased Profitability

The staffing leverage and ease of supervision mentioned above allows franchise organizations to run in a highly profitable manner. Since franchisors can depend on their franchisees to undertake site selection, lease negotiation, local marketing, hiring, training, accounting, payroll, and other human resources functions (just to name a few), the franchisor’s organization is typically much leaner (and often leverages off the organization that's already in place to support company operations). So the net result is that a franchise organization can be more profitable.

Unfortunately, it is difficult to quantify or prove this contention. This much we do know: Research done during the past 10 years shows top quartile franchisors put an average of 40 and 45.6 percent to the bottom line in 2001 and 2002 respectively. How many industries can you think of where net incomes in this range are even possible?

7. Improved Valuations

The combination of faster growth, increased profitability, and increased organizational leverage helps account for the fact that franchisors are often valued at a higher multiple than other businesses. So when it comes time to sell your business, the fact that you're a successful franchisor that has established a scalable growth model could certainly be an advantage.

When the iFranchise Group compared the valuation of the S&P 500 vs. the franchisors tracked in Franchise Times magazine in 2012, the average price/earnings ratio of franchise companies was 26.5, while the average P/E ratio of the S&P 500 was 16.7. This represents a staggering 59 percent premium to the S&P. Moreover, more than two-thirds of the franchisors surveyed beat the S&P ratio.

8. Penetration of Secondary and Tertiary Markets

The ability of franchisees to improve unit-level financial performance has some weighty implications. A typical franchisee will not only be able to generate higher revenues than a manager in a similar location but will also keep a closer eye on expenses. Moreover, since the franchisee will likely have a different cost structure than you do as a franchisor (she may pay lower salaries, may not provide the same benefits packages, etc.), she can often operate a unit more profitably even after accounting for the royalties she must pay you.

As a franchisor, this can give you the flexibility to consider markets in which corporate returns might be marginal. Of course, you never want to consider a market you don't feel provides the franchisee with a strong likelihood of success. But if your strategy involves developing corporate units in addition to franchising, you'll likely find your limited capital development budget won't allow you to open as many locations as you'd like. Franchisees, on the other hand, could open and operate successfully in markets that are not high on your priority list for development.

9. Reduced Risk

By its very nature, franchising also reduces risk for the franchisor. Unless you choose to structure it differently (and few do), the franchisee has all the responsibility for the investment in the franchise operation, paying for any build-out, purchasing any inventory, hiring any employees, and taking responsibility for any working capital needed to establish the business.

The franchisee is also the one who executes leases for equipment, autos, and the physical location, and has the liability for what happens within the unit itself, so you're largely out from under any liability for employee litigation (e.g., sexual harassment, age discrimination,

EEOC), consumer litigation (the hot coffee spilled in your customer's lap), or accidents that occur in your franchise (slip-and-fall, employer's comp, etc.).

If buying an existing business doesn't sound right for you but starting from scratch sounds a bit intimidating, you could be suited for franchise ownership. Just what is a franchise--and how do you know if you're cut out to be a franchisee? Essentially, a franchisee pays an initial fee and ongoing royalties to a franchisor; in return, the franchisee gains the use of a trademark, ongoing support from the franchisor, and the right to use the franchisor's system of doing business and sell its products or services.

Figure 4

In addition to a well-known brand name, buying a franchise offers many other advantages that aren't available to the entrepreneur starting a business from scratch. Perhaps the most significant is that you get a proven system of operation and training in how to use it. New franchisees can avoid a lot of the mistakes startup entrepreneurs typically make because the franchisor has already perfected daily operations through trial and error.

Reputable franchisors conduct market research before selling a new outlet, so you'll feel greater confidence that there's a demand for the product or service. The franchisor also provides you a clear picture of the competition and how to differentiate yourself from them.

Finally, franchisees enjoy the benefit of strength in numbers. You'll gain from economics of scale in buying materials, supplies and services, such as advertising, as well as in negotiating for locations and lease terms. By comparison, independent operators have to negotiate on their own, usually getting less favorable terms. Some suppliers won't deal with new businesses or will reject your business because your account isn't big enough.

Once you've decided a franchise is the right route for you, how do you choose the right one? With so many franchise systems to choose from, the options can be dizzying. Start by

investigating various industries that interest you to find those with growth potential. Narrow the choices to a few industries you're most interested in, then analyze your geographic area to see if there's a market for that type of business. If so, contact all the franchise companies in those fields and ask them for information on their franchise opportunity. Any reputable company will be happy to send you information at no cost.

Of course, you shouldn't rely solely on these promotional materials to make your decision. You also need to do your own detective work. Start by visiting your library or going online to look up all the magazine and newspaper articles you can find about the company you're considering. Is the company depicted favorably? Does it seem to be well managed and growing?

Once you've decided on a certain franchise through your preliminary research, you need to find out if this opportunity is as good as it sounds. Your next step is to analyze it thoroughly to determine whether it's really worth buying.

Much of the information you'll need to gather in order to analyze a franchise will be acquired through the following:

- Interviews with the franchisor
- Interviews with existing franchisees
- Examination of the franchise's Uniform Franchise Offering Circular (UFOC)
- Examination of the franchise agreement
- Examination of the franchise's audited financial statements
- An earnings-claim statement or sample unit income (profit-and-loss) statement
- Trade-area surveys
- List of current franchisees
- Newspaper or magazine articles about the franchise
- A list of the franchisor's current assets and liabilities

Through this research, you want to find out the following:

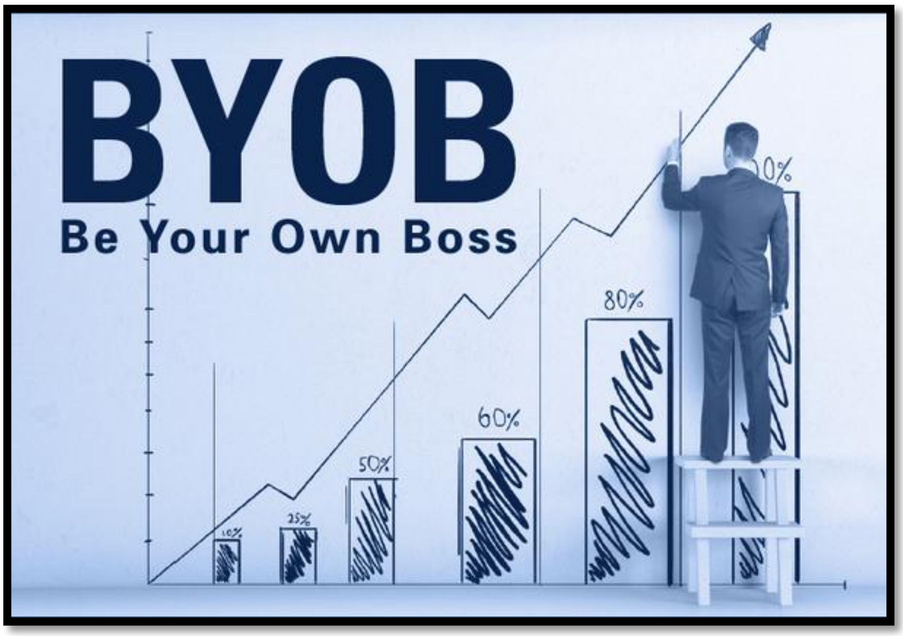
- If the franchisor--as well as the current franchisees--are profitable
- How well-organized the franchise is
- If it has national adaptability
- Whether it has good public acceptance
- What its unique selling proposition is

- How good the financial controls of the business are
- If the franchise is credible
- What kind of exposure the franchise has received and the public's reaction to it
- If the cash requirements are reasonable
- What the integrity and commitment of the franchisor are
- If the franchisor has a monitoring system
- Which goods are proprietary and must be purchased from the franchisor
- What the success ratio is in the industry

Don't be shy about asking for the required materials from the franchisor. After all, they'll be checking you out just as completely. If they aren't, that should sound a warning bell. Another warning sign is if the franchisor asks you to sign a disclaimer stating you haven't relied on any representations not contained in the written agreement. Such a requirement could indicate the franchisor doesn't want to be held responsible for claims made by its sales representatives.

Conclusion:

Becoming your own boss always involves a risk. When you buy a franchise business, you take a calculated risk that eliminates a lot of the pitfalls and potential for failure that come with a start-up. For the budding entrepreneur who lacks hands-on experience or confidence, a franchise can be an excellent starting point versus a non-franchised concept, but you have to do your research and not simply rely on a franchisor's well-scripted and slick sales pitch. After all, it is up to you, not them, to build your business.



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